# COMMONWEALTH OF MASSACHUSETTS DEPARTMENT OF PUBLIC UTILITIES

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Investigation by the Department of Public	)	
Utilities on its own Motion into Rate	)	
Structures that will Promote Efficient	)	D.P.U. 07-50
Deployment of Demand Resources	)	

# WESTERN MASSACHUSETTS ELECTRIC COMPANY'S INITIAL COMMENTS

September 10, 2007

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#### **EXECUTIVE SUMMARY**

WMECO's initial comments consist of the attached material in addition to the comments submitted today by John J. Reed and James D. Simpson of Concentric Energy Advisors and Lawrence Kaufman of Pacific Economics Group under separate covers. In its comments, WMECO supports the Department of Public Utilities' ("Department") effort to implement rate structures and revenue recovery mechanisms that may reduce disincentives to the efficient deployment of demand resources in the Commonwealth.

The Department's straw proposal sets out a process by which current rate recovery tied to sales of electricity and gas would be replaced by the recovery of a fixed amount of revenues per customer, for each customer class, through a rate case. Each year there would be a reconciliation proceeding in order to compare actual revenues with allowed revenues. In general, the Department's straw proposal contains many productive ideas that could be used to implement a base revenue adjustment mechanism or decoupling. Certain of the details need more debate, such as whether a rate case is needed in all cases to initiate rate decoupling, the role of rate class in collecting the needed revenues, and the benefits of continuing the reconciling adjustments the Department has already seen fit to include in rates.

Of equal importance to the collection of revenue through decoupling is how the other part of the utility equation, the collection of the increasing costs to operate utility systems, will be treated. Decoupling may well assist in removing the incentive to sell more units of electricity but, by itself, does not address funding for the increases in operation and maintenance costs and increases in capital expenditures. These costs, in part, have been addressed in utility rate plans, sometimes through settlements. Elements of these rate plans are called performance-based ratemaking or PBR. In this proceeding, the Department should reiterate the need for long-term rate plans as an integral component of a balanced ratemaking approach.

As a whole, the rate plan that has been employed in California for a number of utilities and known generically as the California model has much to recommend it. This plan uses forecasted costs, decoupling, recovery of operation and maintenance costs, a capital replacement program recovery mechanism, and periodic true-ups in order to arrive at a result that removes disincentives to demand resources while also providing utilities an opportunity to recover their costs and operate a safe and reliable system.

Finally, while it is reasonable to assume that the implementation of decoupling will have some effect on the perceived risk of a utility business it is too early to know in which direction all the risk factors point. The Department should not move to adjust any company's rate of return until additional research can be conducted over a sufficient length of time.

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### WESTERN MASSACHUSETTS ELECTRIC COMPANY'S INITIAL COMMENTS

#### I. <u>INTRODUCTION</u>

On June 22, 2007, the Department of Public Utilities ("Department") issued an Order ("June 22 Order") opening an investigation into rate structures and revenue recovery mechanisms that may reduce barriers and disincentives to the efficient deployment of demand resources in Massachusetts. The June 22 Order included a straw proposal for a base revenue adjustment mechanism that severs the link between electric and gas companies' revenues and sales and, instead, ties company revenues to the number of customers served. The June 22 Order also included a request for comments on the elements of the straw proposal, and a further request to address thirteen specific questions. In submitting comments, the Department encouraged interested persons to present consensus positions and submit comments jointly.

In response to the Department's request, Western Massachusetts Electric Company ("WMECO" or "the Company") submits comments in two ways. First, in response to the request to submit comments jointly, WMECO has worked with other electric and gas companies and has signed on to the comments of John J. Reed and James D. Simpson of Concentric Energy Advisors and Lawrence Kaufman of Pacific Economics Group. Those comments are being submitted under separate cover. In addition, WMECO offers the following WMECO-specific comments in response

to the Department's questions. As an initial overall comment, WMECO supports the Department in its efforts to pursue decoupling and thus remove any barriers that may exist to deployment of additional demand side measures. The task, in WMECO's view, is not whether decoupling should be implemented, but to implement it in the most appropriate, most fair, possible manner.

#### II. RESPONSES TO DEPARTMENT INQUIRIES

#### **Allowed Revenue per Customer**

1. The Department's proposal that a company's allowed revenues per customer be determined through a subsequent base rate proceeding is intended to ensure that the allowed revenue levels, which serve as a basis for the base revenue adjustment mechanism, are closely aligned with the company's costs. Under what, if any, circumstances should the Department permit a company's allowed revenues per customer to be determined through some manner other than a base rate proceeding?

WMECO agrees that setting the allowed revenue per customer ("RPC") in a base rate proceeding should insure that allowed total revenues are closely aligned with costs. WMECO, however, believes that allowed revenue per customer could also be established based on current rates in the absence of a rate case. If a utility is currently under a rate settlement or PBR plan, it would be reasonable to apply the RPC decoupling mechanism based on the settlement base rate billing determinants or the specific annual PBR determinants. In this way the decoupling mechanism would apply to the already determined total allowed RPC (that is, it would insure recovery based on the inherent kilowatt-hour and kilowatt per customer characteristics), and total revenue recovery would align with whatever inflationary costs are inherent in the approved settlement or rate plan. This method of implementing decoupling avoids the complex issues surrounding the adjudication of a base rate case.

As is discussed in the comments of Messrs. Reed, Simpson and Kaufman and in answers to questions below, the larger question concerning the Department's straw proposal is that it appears to contemplate that total revenues under the RPC decoupling mechanism grow only proportionally to

the growth in customer counts. This methodology does not take into consideration inflationary increases in utility distribution cost of service (increases in capital expenditure costs as well as operations and maintenance are particularly important here), nor does it recognize that distribution cost of service is also impacted by peak demand growth. Only if customer growth were approximately equal to inflation plus demand growth would revenues continue to align with costs beyond the base rate year period.

If the Department intends to use the RPC decoupling mechanism as a long term rate plan, then it is imperative that a sufficient escalation factors be included to account for increases in the cost of service. It must be recognized that decoupling only addresses revenue recovery. It has no bearing on the utility's cost of service. Some form of rate plan with cost adjustments is necessary to account for the increasing revenue requirements over time. An RPC decoupling mechanism can easily be included in a longer term PBR-type rate plan, but it cannot replace a longer term rate plan. Including decoupling with PBR-type rate plan would enable the utility's allowed revenue requirement to align with reasonable changes in cost of service, and then decouple that specific allowed annual revenue requirement from customer usage (making utilities indifferent to increased or decreased use per customer within the rate plan period). It should be noted that this type of decoupling model is consistent with the approach used in California for a number of years.

2. The Department's proposal uses an approach in which a company's allowed revenues per customer for each rate class does not change between base rate proceedings. An alternate approach would be to adjust the allowed revenues per customer values periodically, based on changes in each rate class' average usage per customer. Please discuss the merits of each approach.

The Department's proposal to reconcile actual RPC with allowed RPC insures that under any circumstance the utility will recover the intended RPC times actual number of customers. In this regard, if the actual average use per customer increases or decreases, the RPC mechanism will increase or decrease the overall average rate to recover the revenue deficiency associated with

reduced consumption. Therefore, the actual billed RPC will vary naturally by virtue of the decoupling mechanism. It becomes a matter of semantics as to whether the allowed RPC is constant and the decoupling mechanism charge varies to reflect actual usage, or the allowed RPC varies as actual usage changes, and thus the decoupling mechanism is more constant. This is the same concept as a base energy charge and fuel adjustment. It is the total of the base rate plus adjustment that is relevant to both customers and the utilities. If the base is smaller, then the adjustment is larger, and vice versa.

As discussed elsewhere in these comments and in WMECO's response to the Department's data request, DPU 1-1, it is not sufficient to establish an RPC that does not change and expect this will be a sufficient rate-setting policy. The Department could adjust the allowed RPC periodically. However, it is preferable to institute a rate plan that accompanies decoupling that explicitly addresses WMECO's growing costs to serve its customers.

#### **Annual Reconciliation Calculation**

3. The Department's proposal that a company's actual versus allowed revenues be reconciled annually is intended to balance three objectives: rate stability, rate continuity, and administrative efficiency. Do annual reconciliations strike an appropriate balance among these three objectives or would alternate reconciliation periods (e.g., quarterly or semi-annually) better do so?

WMECO supports the Department's proposal to reconcile revenues on an annual basis. It is appropriate to reconcile and adjust rates on an annual basis because it promotes a period of rate stability for customers. Many businesses rely on stability when planning their operational budgets so businesses will now know that the rates are fixed for a 12-month period. Reconciling and adjusting utility rates annually will provide business customers in WMECO's territory a planning tool to assist in the management of their business expenses.

The annual reconciliation process also provides rate continuity if the annual reconciliation is aligned with a calendar year. Many businesses including WMECO tend to plan their fiscal operation

on this time period so that the annual reconciliation period will be a useful management tool for WMECO's customers and all Massachusetts utility customers. If the Department were to extend or shorten the reconciliation period outside of the 12-month period, it could create larger swings in revenue true-ups. Shorter reconciling periods could be affected by weather seasonality while longer reconciling periods could be impacted by such issues as changing economic conditions.

WMECO also supports the proposal from an administrative perspective. The Department already deals with many reconciling mechanisms that presumably will not be eliminated by decoupling. Some of these reconciling mechanisms are: Transition Charge, Transmission, Residential Assistance Adjustments, Default Service and Pension/PBOP Mechanisms. The Department could include the annual reconciliation related to any decoupling proposal with the reconciliation review of the above mechanisms.

The Department should also recognize that a revenue reconciliation mechanism is an integral part of WMECO's and other utilities' ability to earn their allowed rate of return as approved by the Department. Therefore it is important that WMECO and other utilities implementing the Department's proposal be allowed to calculate carrying charges on the over/ under-recovery that could occur under this proposal. The carrying charge should be at the company's cost of capital rate of return given that the proposal impacts the company's earnings.

4. The Department's proposal to determine a company's actual revenue based on billed revenues is consistent with the base rate treatment applied to distribution-related bad debt costs. An alternate approach would be to determine actual revenue based on payments received. Please discuss the merits of each approach.

WMECO supports the use of billed revenues as a method to determine actual revenues for decoupling purposes. This methodology has been implemented in other tracking mechanisms with success. Currently, customer rates reflect timing differences between customer bills and actual payments by recognition of bad debt and working capital. This method creates rate stability.

Developing decoupling revenues on customer payments is untested and may expose the reconciliation process to significant swings in revenue recoveries therefore exposing the customer to notable surcharges or credits reducing rate stability. Customer payments may vary depending on the cost of energy and the ability of customers to pay in a timely manner. A customer's payment may be affected by economic conditions, seasonality and company payment terms.

- 5. The Department's proposal for determining billed revenues is based on actual consumption. An alternate approach would be to determine billed revenues based on consumption normalized for weather and/or other factors.
- (a) Please discuss the merits of determining billed revenues using actual versus weather-normalized consumption.

The Department has had a long standing practice of using actual consumption when setting electric customer rates. Rates can be set using consumption other than actual volumes. Other options available to the Department are weather normalized or projected/forecasted consumption. The important key in using other than actual consumption is that initial or "kickoff" customer rates/revenue must be designed on the same type of consumption volumes as the decoupling revenue is based on. In other words there must be synchronization throughout the ratemaking process to reflect other than actual numbers (*i.e.*, all numbers must be weather normalized). Customer rates cannot be designed on actual customer consumption levels and the billed revenues for decoupling set on some other type of consumption volumes (*e.g.*, weather normalized); otherwise a continual disparity of revenue recovery will occur affecting both the customer and the company. For example, if a total dollar revenue requirement is determined for a company then the type of consumption level used to determine customer rates must also be the same type of revenue that is used to set the decoupling revenue.

(b) Should consumption be normalized for other factors (e.g., economic conditions)? If so, identify those factors and describe how the normalization for such factors could be done.

Because WMECO supports the Department's proposal for annual revenue reconciliation, other factors such as economic conditions would not play a role in determining the level of consumption for decoupling purposes. Factors such as economic conditions tend to impact revenue and cost streams over a longer period than a year and would be recognized as part of a more traditional base rate filing including a longer term rate plan.

#### **Annual Base Rate Adjustment**

6. The Department's proposal to recover the difference between a company's target and projected revenues through adjustments to its base energy charges is intended to send appropriate price signals to consumers. An alternate approach would be to adjust both base energy and demand charges (where applicable) to recover this difference. Please discuss the merits of each approach.

The Department's straw proposal calls for distribution revenues to be reconciled on a rate class basis and for any over-/under- recovery to be returned/collected within that rate class.

WMECO's various rate classes have different rate structures. All rate classes, except the streetlighting rates, have customer charges and energy charges. The rate classes serving medium and large commercial and industrial customers also have demand charges. A RPC decoupling mechanism recognizes that a utility's distribution cost of service is largely a set of fixed costs, with little if any relationship to kilowatt-hour consumption. In this regard both the customer and demand charges are the theoretically correct components to recover all distribution costs, and, thus, changes to those components would send an appropriate price signal regarding utility cost of service. Rate design, however, rarely mirrors utility cost of service as some level of subjectivity may be appropriate.

For rates that include a demand charge, it would be appropriate to adjust either or both the customer and demand components to send the appropriate price signals to those customers.

Adjusting the distribution energy charge for customers that have no demand charge sends a price signal to conserve as the price increases. However, cost of service theory may warrant a change to the customer charge as an alternative. For larger customers that also have demand charges, only changing the energy component of the distribution rate may distort the rate class' rate structure. The largest commercial and industrial rate classes have time differentiation reflected in their distribution rates, peak and off-peak periods. Changing only the energy charge on an equal cents per kilowatt-hour basis will distort the price differentiation of the peak and off-peak periods, sending a wrong price signal to these customers. To lessen the distortion, both demand and energy charges should be adjusted reflecting any time differentiation.

#### **Reconciliation Filings**

- 7. The Department's proposal to require a company to submit quarterly filings identifying actual and allowed revenues is intended to ensure that changes in rates are made in a predictable and gradual manner.
- (a) Under what circumstances should the Department allow an adjustment in base charges during a reconciliation period?

An adjustment during a reconciliation period, such as a quarterly adjustment, could be administratively burdensome for the Department to review, and is not needed. WMECO recommends that a threshold or bandwidth be implemented that measures the fluctuation between the allowed and actual revenues during the reconciliation period. A change in rates should be allowed if the change in revenue is outside the bandwidth in between annual reconciliations.

(b) Under what circumstances should the Department initiate a review of a company's base revenue adjustment mechanism?

Should a company believe that the adjustment mechanism is not working in the way it was intended, the Department should, upon the request of a company, initiate a review. For example, the

mechanism should result in expeditious annual true-up decisions. If the mechanism does not produce this result it would be appropriate to investigate other reconciliation processes.

8. What standards should the Department use to measure the performance of a company's base revenue adjustment mechanism over time?

Evaluation of the company's base revenue adjustment mechanism will be complex. The motivation for the mechanism is to provide an incentive for the deployment of additional demand side resources. One measure of success, then, is the growth of demand side resources over a period of years in the company's service territory. However, there are many factors that will influence the growth of demand side resources other than decoupling (*e.g.*, energy prices) and all those factors will have to be taken into account.

#### **Change in Risk**

9. How will the implementation of a base revenue adjustment mechanism affect a company's risk and how should such considerations be reflected in a company's capital structure and ROE?

It is too soon to determine what effect, if any, that a base revenue adjustment may have on WMECO's risk profile. An initial review of the Department's straw proposal indicates it has essentially no major impact on WMECO's risk profile because it:

- does not eliminate weather or economic risk;
- does not protect the Company from operating cost increases; and
- is not a fully tracking tariff that ensures that WMECO will earn its allowed ROE but provides a bandwidth that appears to be too wide as proposed.

This is not to say that there will be no benefit to WMECO's financial stakeholders over time because a base revenue adjustment mechanism:

- provides motivation to customers to reduce consumption and their associated electric costs;
- will stabilize the Company's cash flows; and

• could be a positive development that could result in improved credit ratings.

In sum, there are a number of areas that may change and should be examined over time to determine. During the initial period after implementing a base revenue adjustment mechanism, the Department should take a very cautious approach when considering making any change to WMECO's allowed ROE.

#### **Shared Earnings Provision**

10. The Department's proposal to include a shared earnings provision in the base revenue adjustment mechanism is intended to strike an appropriate balance between the risks borne by customers and shareholders associated with company earnings. Please comment on the merits of such a provision. Also, comment on the design of the proposed earnings sharing provision.

WMECO does not support a shared earnings provision for a base revenue adjustment mechanism. This type of provision is inappropriate for a mechanism that only looks to reconcile revenue and does not look at the cost side of the business. WMECO currently has several tracking mechanism that true-up revenues to costs on an annual basis (*e.g.*, the pension/PBOP tracker), that do not include shared earnings provisions. Therefore, WMECO concludes that a base revenue adjustment mechanism that does not include a cost adjustment mechanism should not include a shared earnings provision. Please also see the response to Question 11.

#### **Performance Based Regulation**

11. Please comment on the merits of implementing a base rate adjustment mechanism with and without the individual elements of a PBR plan (e.g., fixed term, inflation, productivity, performance standards, exogenous factors).

The Department's proposal to decouple sales and revenue is an appropriate step in order to create customer rate stabilization, continuity and promote customer conservation. However, the Department's proposal for decoupling only focuses on a company's revenue stream and customer

rates. Individual PBR mechanisms or longer term rate plans recognize a company's changing costs. While WMECO and other utilities work diligently to control operating costs, many costs are out of the utilities' control.

PBR or rate plans which deal with inflation, productivity and exogenous factors are extremely important to both the company and the customer. These mechanisms adjust customer rates in a controlled fashion and allow companies such as WMECO to recover costs that are otherwise out of its control. Adjustments for inflation when joined with productivity recognize changes in a company's costs due to economic issues but temper these changes by the inclusion of a productivity factor. Exogenous factors recognize industry and government changes that cannot be anticipated by the company. None of these mechanisms to date have addressed a utility's need to invest capital in its system. PBR mechanisms or other rate plans should be included with the Department's decoupling mechanism to provide the ultimate customer rate stabilization program. With a proper decoupling plan paired with an appropriate long-term rate plan, it will lessen the need for companies to file traditional rate case requests.

WMECO is currently operating under a shared earnings mechanism of plus or minus 200 basis points around a 10.0% ROE with 50/50 sharing outside of the 8.0% – 12.0% bandwidth. WMECO's mechanism also contains a provision that when earnings are more or less than 300 basis points from the 10.0% ROE the parties may request to reset rates. WMECO finds that this proposal strikes the proper risk/reward balance for both customers and shareholders. It strikes a reasonable balance for operating in the confines of a rate plan over a period of time without customers or shareholders facing the impacts of earnings volatility. WMECO recommends that the Department approve this type of earnings sharing mechanism for inclusion in a base revenue (decoupling)/cost (PBR) adjustment mechanism.

#### **Implementation Schedule**

12. Please comment on how the Department should schedule the implementation of a base revenue adjustment mechanism for each gas and electric company in light of the need to move expeditiously, the resources required to implement such changes, and the specific circumstances of each company. How should the Department determine the order of individual base rate proceedings?

The manner in which the Department should schedule the implementation of base revenue adjustment mechanisms is part of a larger question of the route the Department chooses for the implementation process. As the Department has recognized, any change to the approach to the setting of rates and charges for jurisdictional companies is not any easy task. June 22 Order, p. 10. This difficulty is compounded geometrically when a fundamental construct of utility rate design for many decades, recovery dependent on the volume of kilowatt-hour sales, is being altered. In such a situation, many basic assumptions and practices that have built up over time need to be re-examined to determine if they fit with the new method. An example of the need for re-examination mentioned by the Department in its June 22 Order is how to treat fully-reconciling charges for expenses recovered through base rates, an increasingly common recovery mechanism. June 22 Order, p. 13, fn. 9.

Because there are differences between companies and a sizable number of jurisdictional companies, it will take a major effort by all those involved, but especially the Department, to establish a base revenue adjustment. However, there is no reason that the Department could not initiate such an effort on a company-by-company basis once it has concluded its investigation in D.P.U. 07-50. Even so, it would take some time, and the Department would be able to gauge this better than WMECO, for the Department to make its way through each individual case. It may be that the process will go more quickly after the Department has experience with the first few proceedings.

The aspect of scheduling that raises additional concerns, given the Department's stated desire to move expeditiously, is the Department's statement tying the base revenue adjustment mechanism to a base rate proceeding. The Department acknowledges that it might be possible to implement an adjustment mechanism without a rate case but indicated that proceeding in this way may "distort prices" and frustrate the "goal of efficient deployment of demand resources." June 22 Order, p. 14. WMECO understands the Department's interest in initiating the revenue adjustment mechanism through a rate case, but such a stance brings additional factors into play.

First, several companies, including WMECO, have multi-year rate settlements and/or PBR plans that have been formally approved by the Department. As a matter of law, WMECO believes that there are legal impediments to abrogating these settlements. In order to avoid that obstacle, the Department would need to wait until these settlements ended according to their terms prior to implementing a rate case/base revenue adjustment proceeding. However, waiting for the settlements to conclude would entail a significant delay in implementation.

Second, the decision to require that a rate case proceeding accompany a base revenue adjustment mechanism will significantly increase the resources required by the Department and all other parties. The setting of a revenue adjustment mechanism, while very complicated, should be basically a revenue-neutral exercise. Setting base rates is, by definition, not revenue neutral, and will bring into play a number of additional parties and a huge number of additional issues. WMECO does not underestimate the difficulty the Department faces in establishing a base revenue adjustment mechanism absent questions concerning the level of base rates. But once base rates are in play the resources required will increase exponentially.

In sum, the scheduling of the base revenue adjustment mechanism and how expeditiously such a mechanism can be implemented is dependent on whether the Department views the base revenue mechanism proceeding as an individual component in a system where various components

are examined over time, or whether the implementation of the base revenue mechanism can only be accomplished by a simultaneous, comprehensive view of the company's ratemaking levels and rate path. WMECO supports the Department's efforts to proceed expeditiously in the implementation of the base revenue adjustment mechanism. The Department could proceed along either path, recognizing the pros and cons of each.

#### **Other Questions**

13. How should the implementation of a base revenue adjustment mechanism affect the performance-based shareholder incentives that gas and electric companies currently are eligible to receive for promoting energy efficiency?

The Department has stated that upon the implementation of a base revenue adjustment mechanism, a company's lost base revenue program would be terminated. Order, pp. 18-19. As the Department is aware, WMECO does not have lost base revenue recovery currently and has not had such recovery since the mid-1990s. Since that time, WMECO's compensation for implementing energy efficiency, even though it has never been a full offset for the kilowatt-hours saved, is the performance-based shareholder incentive. Going forward, there is every indication and expectation that electric and gas companies' energy efficiency efforts will continue to be important part of the energy efficiency solution in the Commonwealth. The electric and gas programs have been very effective and an infrastructure has grown up around these efforts. Given the importance of the continuing the existing effective programs, it would be contrary to the public policy set by the Patrick Administration and being implemented by the Department, to eliminate a prime motivator of the programs' success, the shareholder incentive. Therefore, the performance-based shareholder incentive should be continued under any base revenue adjustment mechanism.

### III. <u>CONCLUSION</u>

WMECO appreciates the opportunity to file these comments and the supporting comments of John J. Reed, James D. Simpson and Lawrence Kaufman.